investment in new technologies, in programming services and in other aspects of cable service. Benchmarks based on the pricing behavior of competitive and non-competitive systems rather than on the costs incurred by systems incorporate marketplace judgments regarding investment risks and rates of return and do not require that the Commission make such judgments.

The Coalition attaches a report by two management consultants, which describes its proposed "Cost-of-Service Benchmark Model."[34/] That report leaves to the Commission the task of figuring out how to establish reasonable returns on capital:

> The Commission will perform analyses to determine a norm for the allowable return on capital (E37). The average debt-to-equity mix in cable system acquisitions or construction may be used as a guide to the capital structure. Current interest rate averages for cable debt financings may be used as a guide for the cost of the debt component. The cost of capital should be a weighted average of the cost of debt and the cost of equity, determined by an appropriate method.[35/]

One has to read the fine print of NAB's analysis to identify its assumptions regarding appropriate rates of return. NAB's comments, like the Coalition's, include an attached report

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34/ J.C. Smith & M. Katz, Appendix A: Cost of Service Benchmark Model (Jan. 27, 1993). Even a cursory review of this report belies the Coalition's characterization of its proposed approach as "relatively simple" and "relatively easy for individual communities (or the FCC) to apply." Coalition Comments at v, 49.

35/ Id. at 15 (emphasis added).

describing its "hybrid" approach.[36/] In performing some "back-of-the-envelope"[37/] calculations to show how their proposed approach might work, the authors indicate in a footnote that they have assumed an annual return to capital of 8 percent.[38/] This assumption which, when applied to "some rough-cut, average statistics,"[39/] yields an average basic rate of $4.52 per month,[40/] seems to have been plucked from thin air, and is far below a reasonable return on cable's capital investment.

Indeed, it is far below what the Commission allows in the telephone industry, where investment risk is much lower. For example, the Commission has authorized a rate of return on investment of 11.25 percent for the interstate access services of local exchange carriers.[41/] With respect to basic telephone service, its "price caps" approach allows a carrier an effective maximum rate of return of 14.25 percent.[42/] Given the higher investment risks, a reasonable return to capital in the cable

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36/ Haring, Rohlfs & Shooshan, supra.

37/ Id. at Executive Summary, p. 2.

38/ Id. at 14 n.20.

39/ Id. at 13.

40/ Id. at 14.

41/ Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 7507 (1990).

42/ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 6 FCC Rcd 2637, 2641 (1991).

industry should be significantly higher than in the telephone industry. Off-hand and erroneous assumptions like this regarding the appropriate rate of return will produce benchmark rates that are obviously too low, with draconian and confiscatory results. In sum, NAB fails to recognize the crucial role that rate-of-return determinations play in its benchmark approach and fails to provide any guidance as to how such determinations should be made.[43/]

3. Benchmarks for Basic Rates Should Be Based on Rates of Systems Subject to Effective Competition.

The "global formulaic cost approach" of CFA and the cost-of-service benchmark approaches of the Coalition and NAB are unduly cumbersome and unreliable in identifying basic rates that reflect those that would be charged if a system were subject to effective competition. By contrast, a benchmark approach based on the

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43/ Whatever the merits of cost-of-service benchmarks such as those proposed by NAB and the Coalition, it should be obvious that estimated benchmark rates based on "back-of-the envelope" calculations provide no indication at all of what an appropriate benchmark rate might be. Neither NAB's estimate of a $4.52 basic tier nor the Coalition's estimated cost-per-channel of 32 cents is derived from the sort of analysis that their proposed approaches would require. NAB's, as shown above, uses "rough-cut average statistics." As the authors note, "[r]esults in any particular circumstance would obviously depend on the particulars of that circumstance, but this example illustrates the fundamental issues." Haring, Rohlfs & Shooshan, supra, at 13-14 (emphasis added). And the Coalition's is based on an "interim method" that has nothing to do with cost-of-service measurements and simply represents "an estimate of the monopoly component in rates" by the Coalition's management consultants. Coalition Comments at 49.

rates actually charged by systems subject to effective competition would have neither of these problems.

First, as described in NCTA's initial comments, such an approach would be easy for cities to apply. The Commission would issue a chart or matrix identifying benchmark rates for systems with particular characteristics. A city would simply find the appropriate box on the chart, and its system's benchmark price would be in plain view. Second, no guesswork on the part of the Commission would be required to determine, for example, how to inflate 1986 rates to an appropriate "competitive" level, or what rate of return ought to be allowed to approximate "competitive" returns. The prices of systems facing effective competition would themselves provide the relevant standard of comparison.

The organizations representing most franchising authorities in the United States agree with the cable industry that "a benchmark model based on rates charged by cable systems subject to effective competition would best achieve Congress' statutory goals."[44/] As the National Association of Telecommunications Officers and Advisors, National League of Cities, United States Conference of Mayors, and National Association of Counties ("Local Governments") explain,

> First, since it is based on competitive cable systems, such a benchmark would meet the primary

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44/ Comments of the National Association of Telecommunications Officers and Advisors, National League of Cities, United States Conference of Mayors, and The National Association of Counties ("Local Governments") at 41.

> congressional directive to ensure that subscribers in areas not subject to effective competition pay 'reasonable' rates that are no higher than those paid by subscribers in areas subject to effective competition -- thus eliminating the monopoly rents of cable operators. Second, the benchmark would accomplish the secondary congressional directive of ensuring that the regulatory structure not impose undue administrative burdens on subscribers, cable operators, franchising authorities, or the Commission.[45/]

45/ Id. at 41-42 (emphasis in original). The Attorneys General of Pennsylvania, Massachusetts, New York, Ohio and Texas ("State AGs") also agree that "[t]he use of the rates produced by head to head cable competition as a benchmark is fair, imposes no unusual administrative burdens on the Commission, and is superior to the other benchmark rates proposed by the Commission." State AGs' Comments at 6-7. The State AGs also dismiss the notion that obtaining sufficient data on rates charged by "competitive" systems would be difficult or that the number of such systems is too small to yield reliable results:

> [T]he use of this benchmark should not impose any undue burden on the Commission. There are relatively few (perhaps fewer than 100) markets in which there is competition between or among cable companies, and the Commission could gather all of the relevant data within a short period of time. to the extent that cable operators subject to cable competition are insufficiently diverse to permit the application of this benchmark rate directly to all cable companies, the Commission would make reasonable extrapolations from the available data.

Id. at 7. In our comments, we showed how, if it is impossible to conduct a statistically reliable regression analysis on the relatively small number of "competitive" systems, the Commission could instead compile a matrix of rates for all systems and use data from systems subject to effective competition to identify a "competitive adjustment" to be applied to such rates. See NCTA Comments at 24-25; Owen, Baumann and Furchtgott-Roth at 11-15.

The benchmark approach proposed in NCTA's initial comments appears to be consistent with what the Local Governments have in mind. For example,

> Local Governments would support the creation of a matrix of benchmark rates -- with differences in the matrix rates being based on system characteristics (e.g., plant miles, channel capacity, population density) to which the Commission believes rates are sensitive -- so long as a franchising authority can easily determine which matrix rate its cable system may charge.[46/]

NCTA proposed an approach that would establish a "matrix" of benchmark rates, "based on selected readily observable key characteristics."[47/] Those characteristics would be determined on the basis of econometric analysis, which could "identify those demand- and cost-related factors that are important in explaining the variations in rates (for basic service) among regulated systems."[48/] Moreover, by identifying and taking into account those cost-related factors that significantly affect basic rates, this approach meets the Act's requirement that the Commission take into account costs that are reasonably and properly allocable to basic service.[49/]

46/ Id. at 43.

47/ Owen, Baumann and Furchtgott-Roth supra, at 12.

48/ Id. at 10.

49/ See Act, Sec. 623(b)(2)(c)(ii) and (iii). As discussed in our initial comments, this approach would also take into account ""the direct costs (if any) of obtaining, transmitting, and otherwise providing signals carried on the basic service tier," Sec. 623(b)(2)(c)(ii), as well as

(Footnote continues on next page)

The Local Governments also "would support either a simple national benchmark rate (e.g., X rate) or a 'zone of reasonableness' benchmark rate (e.g., X rate ± Y), so long as such rate is 'reasonable' and eliminates monopoly rents."[50/] NCTA's proposed approach contemplates a "zone of reasonable rates," which should, as explained by Owen, Baumann and Furchtgott-Roth, extend to "[t]he upper end of the range of rates"[51/] found among competitive systems:

> Another key step in the process of establishing a competitive benchmark rate for basic service is to choose a particular rate from among those in the range within each cell, which have already been adjusted to reflect the effect of competition, in order to identify the upper end of the zone of reasonable rates. One possibility is the average or, probably better, the median rate. But to that rate there are two serious objections. First, the median is affected by the likelihood ... that rates in some overbuild communities reflect temporary price wars rather than stable equilibrium competitive prices. Second, to focus on the median competitive price is to lose sight of the fact that one-half of the competitive systems have rates above the median. It would be unreasonable to base benchmark rates solely on the lower half of the range of rates found among competitive systems.[52/]

(Footnote continued)
the costs of franchise fees, taxes and access requirements, see Sec. 623(b)(2)(c)(v) and (vi), by permitting such costs to be passed through or added onto a system's benchmark rate. See NCTA Comments at 30, 41-44.

50/ Local Governments Comments at 43.

51/ Owen, Baumann and Furchtgott-Roth at 15.

52/ Id. at 14.

The Local Governments contend that the Commission's benchmarks

> should require that most cable operators reduce their rates since studies show that most cable rates contain a monopoly rent. At an absolute minimum, the benchmark rate should result in rate reductions for approximately 28 percent of the nation's cable subscribers, which is the percentage of subscribers that Congress found were subject to the most egregious rate increases.[53/]

If the object of the Commission's regulations is to establish benchmarks for basic service that reflect what systems subject to effective competition would charge, and if those benchmarks are based on the rates that such systems actually do charge, there can be no assurance that the benchmarks will result in rate reductions for 28 percent of all cable subscribers. The definition of "reasonable" rates, for purposes of basic rate regulation, is not result-oriented. A system's rates are "reasonable" unless they exceed what systems subject to effective competition charge, not unless they exceed what some percentage of other non-competitive systems charge.[54/]

53/ Local Governments Comments at 43 (citing Act, Sec. 2(a)(1)) (emphasis added). What Congress found, in Sec. 2(a)(1), was that "[s]ince rate deregulation, monthly rates for the lowest priced basic cable service have increased by 40 percent or more for 28 percent of cable subscribers." (Emphasis added).

54/ In this respect, as we discuss in Part III, infra, the Act's standards for basic rate regulation differ from its standards for non-basic rate regulation. In the latter case, there is no separate definition of "unreasonable" rates, in terms of rates charged by competitive systems or in terms of anything else. Moreover, in determining

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In any event, if the Local Governments are right in their belief that systems that are subject to effective competition generally charge lower basic rates than systems that are not, the benchmark approach proposed by NCTA would be likely to lower basic rates for many of the nation's cable subscribers. But if that turns out not to be the case -- if, in fact, most systems' rates for basic service are comparable to those charged by "competitive" systems -- it will not be the benchmarks that are flawed but the assumptions of the Local Governments, CFA, NAB and The Coalition.

In NCTA's comments, we noted that any benchmark approach required "a safety net for special cases"[55/] -- some mechanisms for ensuring that benchmark rates did not prevent operators from making wholly reasonable and desirable expenditures or unconstitutionally prevent them from recovering a reasonable return on capital. One such mechanism proposed by the Commission and endorsed by NCTA would be a procedure by which cable

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(Footnote continued)
whether non-basic rates are "unreasonable," the Commission is directed to look to "rates for similarly situated cable systems" -- including those not subject to effective competition. Act, Sec. 623(C)(2)(A). Thus, unreasonableness, for purposes of non-basic rate regulation, is a relative term and should be defined to encompass only that small proportion of systems whose rates unreasonably exceed the median -- and whose number is not so great as to impose an unreasonable burden on the Commission in dealing with complaints on a case-by-case basis.

55/ NCTA Comments at 33.

operators could rebut the presumptive validity of their relevant benchmarks and "justify higher rate levels based on cost-of-service ratemaking principles."[56/] The Local Governments oppose this proposal, arguing that benchmarks should be completely irrebuttable.[57/] CFA, on the other hand, argues that it is appropriate to make benchmarks rebuttable, but that this safety net should be available both to cable operators and to subscribers:

> The Commission's suggestion that a cost-based showing can be made only to raise rates above the benchmark ... is unbalanced and unfair. Subscribers/interveners must be able to show, by the same principles and methodologies that benchmark rates are too high.[58/]

The Commission's proposal is not unfair. Indeed, it is necessary and appropriate. Benchmarks, as NCTA pointed out in its initial comments, can err in two ways. They can, in some cases, allow a cable operator to charge rates that more than cover costs plus a reasonable profit. Or they can, in other cases, prevent a cable operator from recovering its costs plus a reasonable profit.

In the latter case, there can be no avoiding the need for additional opportunities for the operator to justify its rates. The operator has a constitutional right to be allowed rates that

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56/ Notice, para. 59. See NCTA Comments at 39-41.

57/ See Local Governments Comments at 44-46.

58/ CFA Comments at 110.

are not confiscatory. And, in any event, it is in the franchising authority's own interest not to be bound by a rigid formula, where the resulting rate would necessarily result in a reduction in the quality of service. Cable operators, subscribers and franchising authorities all have an interest in allowing operators to attempt to justify higher rates.

In the former case, where benchmarks allow excessive profits, there are no such compelling reasons for allowing subscribers or franchising authorities to rebut the benchmarks in ratemaking proceedings. First, the constitutional imperative, of course, does not exist in this situation. Second, even if the operator is earning excess profits, it is doing so at prices that do not exceed what "competitive" systems generally charge. The harm to subscribers, therefore, is not severe. Indeed, the operator's additional profits may be attributable to lower costs resulting from greater efficiency. Reducing rates in these circumstances would remove incentives for efficiency and be counterproductive.

Most importantly, the purpose of adopting a benchmark approach rather than cost-of-service regulation, as the Local Governments point out, is to avoid the burdens, delays and uncertainties of ratemaking in favor of simple, readily applicable and predictable standards. Cable operators need to know, in order to plan their businesses and to obtain necessary financing, that they will be able to charge at least a certain maximum rate for a certain level of service, without the prospect

of a ratemaking challenge. Allowing franchising authorities to rebut benchmarks would remove this predictability.

A carefully crafted benchmark approach will minimize the likelihood that basic rate benchmarks will be set too low to allow recovery of costs plus a reasonable profit. A matrix approach that takes into account different cost factors will serve this purpose. So will allowing operators to "pass through" or add on certain cost increases, such as programming costs, franchise fees, retransmission consent fees, and PEG access expenses.[59/] But, ultimately, sound public policy and constitutional guarantees will nevertheless require that cable operators have an opportunity to justify rates in excess of their allowable benchmarks.

II. STANDARDS FOR REGULATING RATES FOR EQUIPMENT USED TO RECEIVE BASIC SERVICE

Section 623(b), which provides for the establishment by the Commission "of basic service tier rate regulation,"[60/] includes a subsection requiring that rates for certain equipment be based on "actual cost". In NCTA's initial comments, we emphasized two principal points with respect to this subsection:

First, we showed that the provision applies to "rates charged for equipment and installation to those who subscribe

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59/ See NCTA Comments at 41-44.

60/ Act, Sec. 623(b).

only to basic service (or to basic service plus premium or pay-per-view channels)."[61/] Second, we argued that the Act requires only that "the rates for equipment, installation and additional outlets combined do not exceed actual costs plus a reasonable profit,"[62/] so that rates for some equipment or installation might be lower than actual costs, while others were higher than actual cost. We maintained that the purpose of this subsection was to prevent cable systems from selling or leasing equipment to basic subscribers at rates that are too high, not to prevent cable systems from somehow attempting to monopolize the equipment marketplace by charging rates that are too low.

As long as overall rates are based on actual costs, this purpose will be met. While some commenting parties dispute the first point, their arguments are unpersuasive. With respect to the second point, franchising authorities and consumer groups that have addressed the issue seem to agree with NCTA's approach.

A. Basic-Only Subscribers Are Entitled to Equipment and Installation at Rates Based on Actual Cost.

Section 623(b)(3) requires rate regulation, on the basis of "actual cost", of equipment "used by subscribers to receive the basic service tier."[63/] Section 623(c), discussed in Part III,

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61/ NCTA Comments at 48 (emphasis added).

62/ Id. at 54.

63/ Sec. 623(b)(3).

infra, allows the Commission on a case-by-case basis, to reduce rates for non-basic service tiers -- i.e., "cable programming services" -- if those rates are "unreasonable." And "cable programming services" are defined to include "installation or rental of equipment used for the receipt of such programming."[64/]

The Local Governments contend that

> the Commission should subject any equipment and installation 'used' to receive the basic service tier to 'actual cost' regulation, regardless of whether it is also used to receive any other programming service(s). The only equipment and installation charges subject to 'unreasonable' rate regulation pursuant to Section 623(c), then, would be that solely used to receive 'cable programming services,' as that term is defined in the 1992 Cable Act.[65/]

As we showed in our comments, Congress intended precisely the opposite -- that the only equipment, installation and additional outlet charges subject to "actual cost" regulation under Section 623(b) would be that solely used to receive basic service. The point of Section 623(b) is to ensure that basic service is provided at "competitive" rates. But "[i]t would do little good to regulate basic service rates in the absence of effective competition if there were no regulatory or competitive constraints on the price of equipment necessary or desirable to

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64/ Sec. 623(l).

65/ Local Governments Comments at 49 (emphasis in original).

receive that basic service."[66/] Congress plugged this regulatory gap by requiring that such equipment rates be priced on an "actual cost" basis.

But equipment provided in conjunction with non-basic tiers of programming is encompassed within the definition of "cable programming services", and rates for such equipment and services are subject to complaints for unreasonableness under Section 623(c). There would have been no reason for Congress to include such equipment in the definition of "cable programming service," if it were also to be subject to "actual cost" regulation under Section 623(b).

The Local Governments contend that

> [t]he Conference Committee specifically amended Section 623(b)(3) to cover installation and equipment 'used' to receive basic service, rather than installation and equipment 'necessary' to receive such service (as proposed in the House bill), in order to 'give[] the FCC greater authority to protect the interest of the consumer. The 1992 Cable Act and its legislative history, thus, do not indicate an intent by Congress to subject cable equipment 'used' to receive basic and other programming services to other than 'actual cost' regulation under Section 623(b)(3).[67/]

But, as NCTA explained in its comments, this change in the statutory language was not meant to extend "actual cost"

66/ NCTA Comments at 47 (emphasis in original).

67/ Local Governments Comments at 48-49, quoting Conference Report at 64 (emphasis added).

regulation to equipment purchased by non-basic subscribers; it had a much narrower and more specific purpose:

> This change was necessary to reach remote control equipment, which Congress clearly meant to place within the scope of the provision. Remote control devices are virtually never necessary to receive basic -- or any other -- cable service.[68/]

The Local Governments also argue that their view that "actual cost" regulation extends beyond equipment purchased by basic-only subscribers

> is supported by the fact that Congress explicitly subjected to 'actual cost' regulation under Section 623(b)(3) an 'addressable converter box or other equipment' used to receive premium and pay-per-view programming.[69/]

But, as NCTA showed, this provision also had a narrower purpose and was only intended to apply to basic subscribers who exercise their statutory option to bypass optional tiers of programming and buy premium or pay-per-view programming:

> Congress recognized and closed the only potential loophole under this approach. Pursuant to the 'anti-buy-through' provisions of Section 623(b)(8), basic service subscribers may purchase per-channel or pay-per-view services without purchasing intermediate tiers of cable programming services. Section 623(b)(8) prevents operators from discriminating against these subscribers, vis-a-vis subscribers to intermediate tiers, 'with respect to the rates charged for video programming offered on a per channel or per program basis.' But unless the rates for equipment used for per-channel or pay-per-view programming were regulated

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68/ NCTA Comments at 49.

69/ Local Governments Comments at 49.

> with respect to basic subscribers exercising their option to bypass intermediate tiers, cable operators could conceivably use rates charged for such equipment to discriminate against such subscribers and deter such bypass.[70/]

In sum, it is not the case that, as CFA contends, "[b]y eliminating the restriction in the original House bill that cost based regulation can only be applied to equipment 'necessary' to receive the basic tier, Congress [sought] to mandate cost based regulation for most equipment used to receive cable service."[71/] To the contrary, only equipment provided to basic-only subscribers (and to basic subscribers who, pursuant to Section 623(b)(8), bypass optional tiers to purchase premium and pay-per-view programming) is required by the statute to be provided on an "actual cost" basis.

B. Individual Items of Equipment Provided to Basic Subscribers May Exceed Actual Cost Plus a Reasonable Profit, as Long as Overall Rates for Installation and Equipment Do Not.

In its Notice, the Commission asked whether the requirement that equipment be sold to basic subscribers on an "actual cost" basis means not only that equipment rates cannot exceed actual cost (plus a reasonable profit) but also that they may not be lower than actual cost. And it asked whether it mattered if individual items of equipment or installation were provided below

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70/ NCTA Comments at 51 (emphasis in original).

71/ CFA Comments at 131 (emphasis added).

or above cost, "as long as provision of equipment in general does recover 'actual costs'"[72/]

NCTA, in its comments explained why there was no reason to prohibit rates lower than cost and why all that mattered, under the Act, was that overall equipment charges to basic subscribers reflected overall actual costs:

> [W]hat Congress sought to ensure was that cable operators, whose basic service rates would now be regulated, not be allowed to extract excessive profits by unbundling equipment and installation and offering them at unregulated, supracompetitive rates.
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> It follows that below-cost pricing of individual items of equipment and installation should not itself run afoul of the Act. Moreover, even above-cost pricing of individual items should not cause problems so long as, overall, the cable operator's charges for unbundled equipment, installation and additional outlets simply cover the operator's direct and indirect costs plus a reasonable profit and are not, therefore, a source of monopoly profits.[73/]

To the extent that they address this issue, consumer groups and franchising authorities seem generally to agree that the Act does not prohibit below-cost pricing of equipment. Thus, CFA "believes the Commission should make a tentative finding that below-cost pricing is not prohibited per se by the Act" -- subject to re-evaluation if, at some future date, "promotional pricing begins to interfere with the development of competition

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72/ Notice, para. 70.

73/ NCTA Comments at 52.

in the equipment and installation markets."[74/] The Local Governments state the point more directly:

> The rates established under the Commission's regulations are simply ceilings for cable rates; the Commission should not interpret them to be floors.[75/]

CFA also agrees that bundling certain items of equipment and installation at a single price or offering some items at a price below cost and others at a price above cost is permitted by the Act, as long as "the overall cost of installation and equipment remains reasonable (i.e., cost based) to comply with Congress' intent."[76/] As CFA explains, the Act simply requires the Commission

> to set a ceiling for these items regardless of whether they are offered individually or as a package. Permitting cable operators to offer installation and equipment as one or more packages or individually gives greater flexibility both to consumers and operators without compromising Congress' intent.[77/]

On this point, therefore, there appears to be a reasonable consensus: What Section 623(b)(3) requires is that, while operators share flexibility to offer some items of equipment and installation at rates below costs and others at rates above cost,

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74/ CFA Comments at 135.

75/ Local Governments Comments at 50.

76/ CFA Comments at 134 (emphasis added).

77/ Id. at 133-34 (emphasis added).

overall rates charged basic subscribers for installation equipment and additional outlets must be based on actual costs and may not exceed those costs plus a reasonable profit.

III. STANDARDS FOR REGULATING RATES FOR "CABLE PROGRAMMING SERVICES"

If there is one thing that is clear from the structure, language and legislative history of the Act, it is that Congress enacted and intended that the Commission implement two wholly different regulatory regimes: one for basic cable service and the other for non-basic "cable programming services."

As we demonstrated at length in our initial comments, Congress adopted a scheme of comprehensive regulation -- primarily by local franchising authorities -- of rates for basic service. Its objective was to make available a low-priced tier of service, including broadcast signals, that would be affordable to most consumers. The Commission was directed to promulgate regulations governing such local regulation that would ensure that rates were "reasonable" -- and Congress made clear that, by "reasonable", it meant that a system's rates should not exceed what would be charged if the system were subject to effective competition.

Congress adopted a wholly different approach to regulation of non-basic "cable programming services." Instead of providing for ongoing regulation of non-basic tiers by local franchising authorities, it assigned the Commission the task of resolving complaints from subscribers or franchising authorities alleging

that rates for such tiers were "unreasonable". This substantial difference in regulatory approach is instructive. Congress could not have believed that most systems' rates for non-basic tiers were unreasonable -- because it could not have expected the Commission to resolve, on a case-by-case basis, complaints regarding even a substantial minority of the 11,000 cable systems in the United States during the first 180 days after the Commission's rules took effect, or following each subsequent rate increase. Indeed, the legislative history confirms that Congress believed only that "some"[78/] cable operators have raised rates unreasonably -- a small "minority"[79/] of "renegades."[80/]

Section 623(b), which provides the framework for basic rate regulation, and Section 623(c), which governs "cable programming service" rates, not only embody fundamentally different procedural frameworks. They also incorporate fundamentally different substantive standards. Section 623(b), as noted, specifically defines "reasonable" basic rates as rates that would be charged if a system were subject to effective competition. Section 623(c) contains no such overriding definition of what, in the context of non-basic rates, is "unreasonable." Section 623(b) contains a list of criteria to be considered by the Commission in developing regulatory standards for basic

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78/ House Report at 33.

79/ Id.

80/ Id. at 30.

regulation. Section 623(c)'s list of criteria for non-basic regulatory standards is almost completely different -- and, unlike the list for basic rate standards, it directs the Commission to consider rates for all similarly situated cable systems, not just systems subject to effective competition.

Notwithstanding these rather obvious differences, the Local Governments argue that the Commission should adopt a benchmark model for determining whether non-basic rates are "unreasonable" that is "the same as that adopted for the basic tier."[81/] The Local Governments

> do not believe that Congress intended the use of different standards of reasonableness for basic service and cable programming services. The fact that Congress requires that basic rates be 'reasonable' and that cable programming service rates not be 'unreasonable' reflects nothing more than a recognition of the active role to be taken with respect to basic rates and the re-active role to be taken with respect to non-basic rates.[82/]

Similarly, the Coalition of seven franchising authorities suggests that "rate[s] for non-basic services can be established by using the same method proposed for establishing basic rates."[83/] And the Attorney General of the State of Connecticut argues that "cable programming services should be regulated in

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81/ Local Governments Comments at 70.

82/ Id. at 70-71 (emphasis in original).

83/ Coalition Comments at 63.

the same manner as basic service...."[84/]

Whatever the appropriate standard for determining in Commission complaint proceedings whether non-basic rates are "unreasonable," it certainly should not and cannot be the same as the standard for determining, in the context of local rate regulation, whether basic rates are reasonable. For all the reasons described above, Congress envisioned a different standard, designed to meet the different objectives of non-basic regulation.

That standard should, as the statutory criteria suggest, define "unreasonableness" in comparison to other similarly situated systems. And, for a large number of reasons identified in the comments of NCTA and others, the standard should deem unreasonable only those rates that far exceed the norm for similarly situated systems. One such reason is that Congress believed that only a small minority of "renegades" had unreasonably abused their market power in raising rates. Another reason is that it would be unreasonable to expect the Commission to handle complaints regarding more than a small minority of the 11,000 cable systems nationwide.

Moreover, as discussed in our initial comments, regulating the rates of non-basic tiers can have adverse effects on the quality of cable programing: "Capping prices of a seller that supposedly possesses market power will not effectively eliminate

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84/ Attorney General, State of Connecticut Comments at 10.

excess profits if the seller is able simply to reduce its costs and offer an inferior product at the regulated price."[85/] Or, as Haring, Rohlfs and Shooshan state, "[t]he conventional method for gaming a price constraint is 'to shrink the candy bar' -- to maintain a profit margin by reducing quality and costs":[86/]

> If a sufficiently flexible formula were not adopted and an average rate were imposed, the ... tiers of systems with above-average program quality (and costs) would deteriorate and systems with below-average ... tiers would make out. There would be strong incentives to substitute low-quality programming for higher-quality programming. The same would be true of customer service efforts.[87/]

CFA also recognizes the problem:

> [T]he general problem with a global formulaic approach is reduction of quality. It is well recognized that given a formulaic, the easiest way to increase profits is to degrade quality.[88/]

85/ NCTA Comments at 56.

86/ Haring, Rohlfs & Shooshan, supra, at 9.

87/ Id.

88/ CFA Comments at 97. CFA's proposed solution to this problem is that the Commission should somehow factor in the quality of programming provided by a system -- quality being defined in terms of viewership. See CFA Comments at 98. It would be inappropriate from a First Amendment standpoint, for the Commission to make judgments as to the "quality" of particular programming. Moreover, Economists Incorporated demonstrate that such an approach would create perverse incentives and "seems specifically designed to discourage innovation in programming. Economists Incorporated, supra, at 14.

The problem is particularly acute with respect to non-basic tiers. The programming on the basic tier -- particularly, broadcast channels and access programming -- is largely beyond the control of the cable operator; the operator cannot reduce the quality of such programming by reducing expenditures. But non-broadcast programming on optional tiers is highly susceptible to spending cut-backs that might accompany reduced rates: "Cable companies would have both the ability and incentive to degrade quality and there would be little the Commission could do to stop them."[89/]

The cable program networks are well aware of what would happen if the Commission's regulations and standards did not make clear from the outset that most systems' non-basic rates would not be deemed unreasonable. As Lifetime Television explains:

> Subjecting non-basic services to extensive rate regulation will force operators to either drop existing services or to refuse to add new services as a means of reducing the cable operator's own costs of providing service. Because the new law allows even a single subscriber or franchising authority to file a complaint challenging the existing non-basic service tier services, all cable operators are at risk of having their present and future non-basic rates challenged regardless of how favorable the price/value relationship is. The Commission must quickly serve notice to the public that a cable operator's non-basic service tier rates will be given a high presumption of reasonableness and that such rates will be found unreasonable in only the small minority of situations where such rates can be considered abusive. If the Commission ... does not establish a mechanism to discourage the filing

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89/ Haring, Rohlfs & Shooshan, supra, at 11 (emphasis added).